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February 27, 2004

VIA ELECTRONIC SUBMISSION

Marlene H. Dortch, Secretary
Federal Communications Commission
445 12th Street, S.W.
Washington, D.C. 20554

Re: Notice of Ex Parte – *CC Docket Nos. 93-193, 94-65 and 94-157*
Verizon Telephone Companies Petition for Reconsideration, "In the Matter of Stale or Moot Docketed Proceedings"

Dear Ms. Dortch:

On February 26, 2004, Gary Phillips, Davida Grant, David Toti, Debbie Clemens and the undersigned, on behalf of SBC, met with Tamara Preiss, Jay Atkinson, Aaron Goldschmidt and Deena Shetler of the Wireline Competition Bureau and Debra Weiner and Andrea Kearney of the Office of General Counsel to discuss the above referenced proceeding. In the meeting, SBC reiterated its legal positions as reflected in its previously-filed comments. Specifically, SBC reviewed the history and the rate base treatment of "other post retirement employee benefits" (OPEB) liabilities and argued that the Commission's prior Orders made clear that its rules in 1996 did not require LECs to deduct accrued OPEB liabilities from their rate bases. During the meeting, SBC utilize the attached document as the basis for the discussion.

Sincerely,

/s/David Cartwright

Attachment

cc: T. Preiss
J. Atkinson
A. Goldschmidt
D. Shetler
A. Kearney
D. Weiner

OPEBS

I. BACKGROUND

A. Rate Base Treatment of Accrued Pension Expense

- In mid-1980s, Financial Accounting Standards Board (FASB) switched to accrual accounting for pension expense.

- LECs were subject to rate of return regulation at the time. Their revenue requirement reflected expense plus a return on their rate base. Because accrued pension expense was an expense item in the revenue requirement (and was therefore recovered directly from ratepayers), LECs were required to make an offsetting deduction from their rate base. The purpose of this deduction was to deny LECs the opportunity to make a return on the money collected from ratepayers related to the accrued, but unpaid pension expense.

B. SFAS-106 (December 1990)

- Established new accounting and reporting requirements for "other post-retirement employee benefits" (OPEBs). Prior to SFAS-106, most companies had recognized OPEB expenses when they were paid. SFAS-106 required companies to treat OPEB costs as expenses during the years the benefits are earned and to record a liability for benefit amounts owed to employees.

- Along with this change, SFAS-106 required companies to recognize on their books the amount of any unfunded OPEB obligation for retired and active employees on the date of the obligation (the "transitional benefit obligation"). To illustrate, if Mary had worked for SBC for 15 years, was expected to retire in 15 more years, and was expected to be paid $100 in OPEBs during her retirement, SBC would have to recognize the net present value of half of the $100 as an accrued liability on its books. Likewise, if Jon was retired and had been paid $30 in OPEBs but was expected to be paid another $70, SBC would have to show the net present value of the $70 accrued liability on its books.

- SFAS-106 gave companies various options for recording the TBO on their books. They could: (1) record the full liability immediately; (2) accrue the liabilities over the average remaining service periods of current employees; or (3) if the average remaining service period was less than 20 years, they could use a 20-year period for amortization purposes.

C. SFAS-106 Authorization Order (December 1991)

- Bureau authorized all carriers to adopt SFAS-.106.

- The Bureau declined to permit carriers to immediately recognize their

TBO obligations because the amounts involved were so large that booking them as one-time expenses would have distorted their earnings. Carriers were instead required to amortize the TBO over the average remaining service period of active plan participants or over a 20-year period.

D. RAO 20 (May 1992)

- Bureau holds: "The following Part 32 accounts *shall be used* to record the effects of SFAS-106 on carrier regulatory books of account." (Emphasis added). It then directed carriers to record the amounts accrued for postretirement benefits in Account 4310, Other Long Term Liabilities.

- Also required carriers to notify the FCC when they implement FASB-106, stating, "[t]his notice shall provide us with the interstate revenue requirement impact for the current year and a projection for the next three years."

- In addition, based solely on a finding that "postretirement benefits are similar to pension expenses recorded in Accounts 4310 and 1410 and as such should be given the same rate base treatment," the Bureau held that "the interstate portion of the unfunded accrued postretirement benefits recorded in Account 4310 should be deducted from the rate base."

E. Rescission Order (March 1996)

- FCC rejected arguments that the Bureau exceeded its authority in its designation of the Part 32 accounts to which OPEB expense must be assigned.

  - "RAO 20 did not change [the accounting rules]; it merely gave needed direction on handling the requirements of a new accounting standard under the existing rules in Part 32."

- FCC agreed with arguments that the Bureau exceeded its delegated authority in ordering LECs to reduce their rate bases by the amount of OPEB liability recorded in Account 4310.

  - "Sections 65.820 and 65.830 of our rules "***define explicitly*** those items to be included in, or excluded from, the interstate rate base. The Bureau cannot properly address any additional exclusions in an RAO letter[.]"

  - Reiterating that its rules *mandated* the rate base treatment of OPEB costs, it noted: "The rate base rules, codified at 47 CFR §§65.800-.830, list the Part 32 accounts that *are to be* included in and excluded from the rate base that telephone companies use to calculate their interstate costs." (n. 3, emphasis added).

- FCC issued NPRM proposing a change in its rules to require that OPEB

costs be deducted from the rate base.

- The NPRM compared OPEBs to pensions and stated that – as was the case with pensions -- the rate base (which are the assets on which a return is permitted) should not include ratepayer-supplied funds: "Our proposal to modify our rate base rules ... is motivated by our continuing concern that zero-cost sources of funds, those funds provided to a carrier without cost to investors, be removed from the rate base. We believe that this proposal properly recognizes that ratepayers should only pay a return on those amounts that the carrier has prudently invested in used and useful plant. ...Where carriers have accrued OPEB costs, but have not paid their OPEB liability, the recovered but unpaid costs are capital available to the carrier at no cost. Consequently, the accrued OPEB liability recorded in Account 4310 should be removed from the rate base as a zero-cost source of funds."

F. 1996 Tariffs and Suspension Order

- Between RAO 20 in 1992 and *Rescission Order* in 1996, LECs had reduced their rate base by the amount of accrued OPEB liability they recognized on their books.

- These rate base reductions had the effect of increasing the LECs' rates of return during that period. Those increased rates of return, in some cases, resulted in increased sharing obligations.

- In their 1996 tariffs, the LECs adjusted their PCI to correct for the excessive sharing that resulted from their adherence to RAO 20 in 1992-1995.

- The Bureau suspended these tariffs for one day and initiated an investigation. The Bureau stated the issue as follows: "[O]ne possible construction of our rules is that all costs, including OPEB costs, not specifically excluded should be included in the interstate rate base. On the other hand, it would be possible to interpret our rules to permit a case-by-case evaluation of the correct rate base treatment of costs not explicitly identified in Part 65. Under this interpretation, the Commission could determine, for example, that OPEB costs should be accorded a particular rate base treatment based on an analogy to other costs. Accordingly, we conclude that the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules that warrants investigation." (¶ 20)

G. 1997 Report and Order

- FCC amended its rules to require LECs to reduce their rate base by the amount of accrued OPEB liability they have recognized on their books. It held "because the amounts recorded in Account 4310 are zero-cost sources of funds, rates should not provide a return on those amounts."

- In so holding, the FCC rejected the LEC argument that OPEB amounts are not ratepayer-supplied funds because they were not factored into pre-price cap rates. The only explanation it gave is one sentence: "To the extent carriers are earning a positive return on assets funded in part by [accrued OPEB liabilities] these carriers are recovering their OPEB costs." (¶ 17)

- FCC also rejected MCI's Petition for Reconsideration of the *Rescission Order.*

  - MCI had raised the very issue the Bureau posited in the *Suspension Order.* It claimed that the FCC has "broad discretion in interpreting [its] rules and that a rule change is not needed to determine the rate base treatment of OPEB." It argued that "because the rate base treatment of pensions was already established, and because pensions are similar to OPEB, [the Commission] can apply the pension rate base rules to OPEB through an interpretation."

  - The FCC rejected MCI's argument, holding that the Bureau did not have delegated authority to require rate base changes based on OPEB expense. It held that"[g]iving rate base recognition to OPEB in Part 65 would constitute a rule change for which proper notice and comment must be given."

II. LECs WERE NOT ONLY NOT REQUIRED TO DEDUCT OPEB LIABILTIES FROM THEIR RATE BASES; THEY WERE NOT *ALLOWED* TO.

- Section 65.800 of the Commission's rules states: "The rate base shall consist of the interstate portion of the accounts listed in § 65.820 that has been invested in plant used and useful in the efficient provision of interstate telecommunications services regulated by this Commission, minus any deducted items computed in accordance with § 65.830.

- This rule gives clear and explicit direction on how LECs are to calculate their rate bases. It ***requires*** LECs to calculate their rate base with reference to the Commission's ***rules*** – specifically §§ 65.820 and 65.830 of those rules.

  - That is why both the *Rescission Order* and the *Order on Reconsideration* note that the Commission's *rules* specify what should and should not be in the rate base:

  - *Rescission Order:* "Sections 65.820 and 65.830 of our rules "***define explicitly*** those items to be included in, or excluded from, the interstate rate base.

  - *Both* orders state: "The rate base rules, codified at 47 CFR §§65.800-.830, list the Part 32 accounts that *are to be* included in and excluded from the

rate base that telephone companies use to calculate their interstate costs." (*Rescission Order, n. 3, Recon Order, n. 16)*

- Thus the *sole* issue in this proceeding is what the Commission's Part 65 rules required with respect to OPEBs at the time.

- That is, in fact, the very issue raised in the *Suspension Order.* That order initiates an investigation of LECs' rate base treatment of OPEBs "under existing rules." (¶ 19) It in no way goes beyond existing rules because any such inquiry would be irrelevant, given § 65.800 of the Commission's rules.

- Both the *Rescission Order* and the *Order on Reconsideration* make clear that LECs were not required to deduct accrued OPEB liabilities under the Commission's rules at the time. The Commission held in both orders that § 65.830 did not include accrued OPEB liabilities among the items to be deducted from the rate base, and it squarely rejected arguments that the Commission could somehow *interpret* § 65.830 as encompassing accrued OPEB liability by analogizing OPEBs to pensions.

    - That is why the Commission issued an NPRM with the *Rescission Order* in order to *change* § 65.830 of the rules.

- Section 65.800 of the Commission's rules is thus dispositive. In fact, if a LEC had deducted an item, such as accrued OPEB liability, that was not encompassed within § 65.830 of the Commission's rules, it would have violated 65.800.

- Even AT&T conceded after the Rescission Order, in its comments on the NPRM issued with that order, that "any change to the [rate base] rules will affect the rate base on a prospective basis and will not affect the pending OPEB investigations because those investigations deal with past OPEB costs." (*Order on Reconsideration* ¶ 22)

- The FCC may not find that, notwithstanding its rules, the "just and reasonable "standard itself compelled the deduction of OPEB liabilities from the rate base. Indeed, AT&T does not even so argue, and for good reason:

    - This is not a case in which the Commission's rules were silent with respect to the issue. (*see above)* In fact, as noted, any deduction of liabilities not covered by § 65.830 of the Commission's rules would have violated § 65.600.

- AT&T's argument that tariff investigations are rulemaking proceedings in which the rules can be changed retroactively is frivolous.

    - The FCC cannot change its rules retroactively in an investigation. Rather, the courts have made it clear that the Commission is required to follow its own rules until such time as it alters them through another rulemaking.

- In fact, the FCC was reversed by the D.C. Circuit when it deviated from its exogenous cost rules in a tariff investigation involving OPEBs. *Southwestern Bell v. FCC,* 28 F.3d 165, 169 (D.C. Cir. 1994) ("[b]oth sides agree that the FCC's statement of its criteria for exogenous cost treatment constituted a rule, not a policy statement. ... Accordingly, the Commission was bound to follow those statements until such time as it altered them through another rulemaking.")

    - AT&T tries to distinguish the *Southwestern Bell* case by claiming that the Commission did not assert its rulemaking authority in the tariff investigation but, rather found only that its existing rules could be interpreted to preclude the exogenous adjustment at issue. But that argument is unavailing because the *Suspension Order* here likewise is limited to the issue of what *existing rules* require: "Accordingly, we conclude that the LECs' rate base treatment of OPEBs raises a substantial question of lawfulness under existing rules that warrants investigation." (¶ 19)

- Equally unavailing is AT&T's argument that the adjustments to the 1996 tariff constituted impermissible exogenous cost changes.

    - The adjustments were not exogenous cost changes. They were adjustments to the PCI to correct for the past errors in calculating the rate of return as required by RAO 20.

- Also wrong is AT&T's third and final argument - that Rule 65.600(d) prohibits LECs from restating their earnings more than 15 months after the end of a calendar year.

    - In fact, the rule does not so provide. It requires that within 15 months of the end of each calendar year, LECs "file a report reflecting any corrections or modifications to their interstate rate of return," but it does not say that a further restatement is not permitted.

        - Indeed, it would be confiscatory for the FCC to adopt such a rule for cases like this, where the Commission's four year delay in resolving the Applications for Review of RAO 20 made it impossible to make the necessary corrections in the 15-month report.

III. WHILE THE LAW IS CONTROLLING HERE, THE POLICY ARGUMENTS IN SUPPORT OF RATE BASE DEDUCTIONS ARE SPECIOUS.

- The Bureau's stated justification – and only justification -- for requiring rate base reductions in RAO 20 was its "opinion that postretirement benefits are similar to pension expenses recorded in Accounts 4310 and 1410 and as such should be given the same rate base treatment." But this was flawed reasoning.

- LECs began accounting for pension expense on an accrual basis in the mid-1980s – *while they still were subject to rate of return regulation.* Under rate of return regulation, LECs' were entitled to a revenue requirement consisting of their expenses plus a return on their rate base. Thus, LECs were able to recover from ratepayers all of their accrued pension expense. Because LECs did not actually have to pay this money to retirees at the time they recovered it from ratepayers, they could earn a return on it during the interim, as if it were an asset in their rate base. But under rate of return regulation, LECs were not entitled to earn a return on their expenses; they were permitted only to earn a return on their rate base. And so the Commission required LECs to reduce their rate base by the amount of accrued pension expense they recovered from ratepayers.

- When the Commission adopted price caps regulation for LECs the PCIs initially were set based on the revenue requirement under rate of return regulation. Thus the PCI reflected full recovery of accrued pension expense.

- Had LECs obtained exogenous treatment of accrued OPEB costs, such that those costs were recovered in full from ratepayers (like accrued pension costs were), rate base reductions would, in fact, have resulted in similar treatment for OPEBs and pension expense. But the FCC denied LEC requests for exogenous cost treatment of OPEBs.

    - While accrued OPEB expenses can indirectly affect LEC price cap rates by reducing sharing obligations, the maximum indirect recovery is one half of that expense, and that savings is not available until the year *after* the expense is booked (*i.e.,* the year the sharing obligation kicks in). Thus accrued OPEB expenses should not be treated like accrued pension expense, and prior Commission decisions that concluded otherwise – though irrelevant to this investigation -- were misconceived.

ADD BACK

- When the FCC implemented price caps, it did not indicate whether add back was required.

- From 1992-1994, different LECs took different approaches with respect to add back. The FCC initiated investigations of those tariffs that had a sharing or low-end adjustment.

- In 1995, the FCC issued an order requiring add back. At the same time, it expressly recognized that its add-back rules were not a clarification, but a substantive rule change that could only be applied prospectively:

    - "Several commenters allege that an add-back adjustment would constitute a substantive rule change to (as opposed to a clarification of) the price cap rules and, therefore, cannot be applied retroactively to render existing LEC tariffs unlawful. ... We agree with commenters that the explicit add-back rule adopted here may, as a legal matter, be applied only on a prospective basis. Accordingly, this rule will first be applied when carriers file their 1995 tariffs." (10 FCC Rcd at 5664)

- The 1995 Order was affirmed on appeal by the D.C. Circuit.

- AT&T nevertheless claims that add back was *implicit* in the sharing mechanism all along. In support of this claim, it cites the Commission's reasoning in its 1995 order that "the add-back adjustment is essential if the sharing and low-end adjustments of the LEC price cap plan are to achieve their intended purpose" and that it never "intended to eliminate the [add-back rules]." It also notes dicta in the background section of the D.C. Circuit decision wherein the court described the above statements as a claim by the Commission that the "add-back rule had been implicit in the sharing rules from the beginning."

    - The FCC did not, in fact, say in its 1995 order that the add-back rule was "implicit" in the sharing rules from the beginning. But what it said in that order is not particularly relevant in any event. Whether or not add-back was required prior to the adoption of the 1995 rule hinges on the information available to LECs at the time they filed the tariffs at issue.

- LECs could reasonably draw at least some inference from the fact that the Commission did not adopt the add-back rule that had applied under rate of return regulation. If the Commission had intended to carry forward that rule, LECs could reasonably infer that it would have.

- That inference was all the more reason given the *stated purposes* of the sharing rules.

    - If the purpose of sharing was to give a refund of "excess earnings" in a

particular year to ratepayers, then it would be reasonable to assume that add back was required. (This was, in fact, the reason for the add back rule under rate of return regulation.)

- In contrast, if the purpose of sharing was – not to effect a refund – but simply to better calibrate the PCI to actual productivity gains on a going forward basis, then it would be reasonable to assume add back was not required.

- The discussion of sharing in the *Price Caps Order* suggests that the sharing mechanism was not intended, as a way of returning excess earnings, but as a way of adjusting the PCI on a going-forward basis to ensure that ratepayers shared the benefits of higher than expected productivity gains:

  - "[W]e recognize the possibility that, despite the extensive record that has been developed and the careful analysis to which it has been subjected, it is difficult to determine a single, industry-wide productivity offset that will be perfectly accurate for the industry as a whole or for individual LECs or market conditions at a given time. The calculation of historical productivity that underlies the productivity factor for the LEC industry as a whole is complex and contentious. ... These possible sources of errors in the productivity offset support the adoption of a backstop program (at least until we acquire additional experience with LEC price caps), to adjust rates in the event that such unanticipated errors in the price cap formula occur." (¶ 120)

    - This makes sense because under price caps (unlike rate of return regulation), over-earnings did not infer unlawful rates.

- Further corroborating the reasonableness of this position is the NPRM in which the FCC proposes to require add back. In that NPRM, the FCC itself recognized that under its then-existing rules, an argument could be made that price cap LECs should base their sharing obligations on actual earnings: "it might be argued that the rate-of-return methodology used to define sharing obligations and lower formula adjustments should be based upon the returns achieved under the rates actually charged during the base year." (¶ 120. *See also* ¶ 133)